KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2012/2013

MAY SEMESTER EXAMINATION FOR THE DEGREE OF MASTER OF ECONOMICS AND MASTER OF ECONOMICS (FINANCE)

EAE 513: INTERNATIONAL FINANCE

DATE: Monday 5th August, 2013 **TIME:** 5.30 p.m. – 8.30 p.m.

INSTRUCTIONS

Answer QUESTION ONE and ANY OTHER TWO

QUESTION ONE

(a) Explain the relationship between the Systems of National Accounts (SNA) and principles underlying the balance of payments. **[5 marks]**

(b) With the aid of well labeled diagrams, explain the Mundell- Fleming Model with fixed and flexible exchange rates under the assumptions of relatively high and low capital mobility **[10 marks]**.

(c) The recent depreciation of currency in Kenya has provided interesting lessons to macroeconomists and policy makers. With the use of relevant equations show how both the elasticities and absorption approaches to the balance of payments could provide an explanation to the above situation. Be sure to present the Marshall- Lerner stability condition for effectiveness of the elasticities approach. **[4 marks]**

(d) Explain the stages of economic integration. At what stage is the East African Community? What are the welfare effects of economic integration? **[6 marks]**

(e) Taking into consideration national income in the open economy:

$c = 200 + 0.85y^d$; $i = 100 - 50r$; $g = 800$; $l = y - 100r$; $m = 600$, tax rate $= 32$ percent; $mi = 20 + 0.25y$; $x = 925$

Where: c is real consumption expenditure
i is real gross investment
g is real government expenditure
l is real money demand
m is real money supply
mi is imports
x is exports

Required:

i. Compute the fiscal policy multiplier and interpret your results **[2 marks]**.

ii. Does an open economy imply any reduction in effects of the policy above? **[2 marks]**

iii. Show that the effectiveness of fiscal policy depends on the money market conditions. **[1 marks]**

QUESTION TWO

(a) Differentiate between Purchasing power parity and interest rate parity models of exchange rate determination. How are they used to predict exchange rates? **[8 marks]**

(b) With the aid of a well labeled diagram, discuss how a balance of payment deficit can be eliminated under fixed and flexible exchange rate regimes. **[7 marks]**

QUESTION THREE

(a) The Kenyan economy is one of the robust economies in the East African Community with the largest GDP. Explain the need for a well-developed futures and contracts market and its implication on investments (both local and foreign) **[9 marks]**

(b) How can policy makers mitigate the volatility of exchange rates in the foreign exchange markets in East Africa? **[6 marks]**

QUESTION FOUR

(a) Demonstrate your understanding of the concept of Dutch disease, outlining its major sources. Are the East African Countries likely to experience this phenomenon in light of the discoveries of mineral? **[5 marks]**

(b) Differentiate between covered interest rate parity and uncovered interest rate parity using elaborate equations. **[6 marks]**

QUESTION FIVE

(a) Compare and contrast the Asset and monetary approaches to the balance of payments. Which of the two is superior in the Kenyan case? Explain **[9 marks]**

(b) Explain the macroeconomic policy goals in an open economy. How can the goals be attained? **[6 marks]**